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# Board Independence in Light of the Murdoch News Corporation Scandal

Elina M. Lae\*

## I. INTRODUCTION

In July of 2011, news broke of a scandal that involved hacking by the U.K. newspaper, *News of the World*, into the voicemails of a murder victim and of relatives of soldiers killed in Afghanistan and Iraq, among others. The U.K.'s top police official has resigned over the scandal,<sup>1</sup> the Prime Minister's Director of Communications has been arrested,<sup>2</sup> and the newspaper itself has been shut down by James Murdoch, CEO of the U.K. subsidiary that owned the paper. Despite all of this, the independent board members of the publicly-traded U.S. parent corporation, News Corporation, have been idle "amid the widening scandal."<sup>3</sup> While no director has publicly denounced News Corporation, as *New York Times* corporate critic Andrew Ross Sorkin would have expected, Thomas J. Perkins, director since 1996, has, in fact, publicly *defended* News Corporation.<sup>4</sup> This is particularly curious because Perkins had also sat on the board of Hewlett-Packard (HP) and resigned from that position while simultaneously accusing "*HP* of illicitly [hacking] *his* personal cell- and home-phone records."<sup>5</sup>

This Article explores the function of the board of directors in light of the Murdoch scandal, with the working hypothesis that there is a link between the board being beholden to the CEO—in this case, me-

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1. Sarah Lyall & Don Van Natta Jr., *An Arrest and Scotland Yard Resignation Roil Britain*, N.Y. TIMES (July 17, 2011), <http://www.nytimes.com/2011/07/18/world/europe/18hacking.html?pagewanted=all>.

2. *Scotland Yard (Metropolitan Police Service)*, N.Y. TIMES, [http://topics.nytimes.com/top/reference/timestopics/organizations/s/scotland\\_yard/index.html?scp=4&sq=andrew%20coulson&st=se](http://topics.nytimes.com/top/reference/timestopics/organizations/s/scotland_yard/index.html?scp=4&sq=andrew%20coulson&st=se) (last updated Aug. 22, 2011).

3. Andrew Ross Sorkin, *Murdoch's Board Stands By as Scandal Widens*, N.Y. TIMES DEALBOOK (July 18, 2011, 9:21 PM), <http://dealbook.nytimes.com/2011/07/18/murdochs-board-stays-silent-as-scandal-widens/>.

4. *Id.*

5. Carol Hymowitz et al., *News Corp. Director Perkins Says He's Leaving Company at 79 Because of Age*, BLOOMBERG (Sept. 2, 2011), <http://www.bloomberg.com/news/2011-09-02/news-corp-names-breyer-to-board-as-directors-tom-perkins-cowley-depart.html> (emphasis added).

dia mogul Rupert Murdoch—and how the board handled the corporate crisis. After putting forth the various possibilities and factors, this Article will seek either to confirm the hypothesis or to put forth an alternative explanation.

Sorkin has tacitly made the inference that the lack of independence of the directors not only is the cause of the reticence of the board with regards to the scandal but also has contributed to the corporation's follies in acquisition decisions. Sorkin has pointed to News Corporation's \$580 million acquisition of MySpace, presumably poor operation of the social networking site and later having to sell it for just \$30 million.<sup>6</sup> Moreover, Sorkin has underscored News Corporation's writing off, in associated losses, nearly half the price of the acquisition of Dow Jones as one of "a series of strategic missteps that appeared to be more about indulging [Rupert] Murdoch's personal interests than helping the company."<sup>7</sup>

In asking whether the News Corporation crisis would have been handled better if the board members had been more independent and in his criticism of the acquisitions, Sorkin seems to have made two assumptions: (1) that board independence improves company performance (discussed in Part III); and (2) that the existing standards for board independence are not high enough (discussed in Part II).

## II. STANDARDS OF INDEPENDENCE

### A. *The Existing Standards for Board Independence Are Not High Enough*

Sorkin has pointed out that seventy-six-year-old Kenneth Cowley<sup>8</sup> is a former, long-term executive of News Corporation; however, under the stock exchange rules, Cowley is considered independent.<sup>9</sup> As other journalists have pointed out, Viet Dinh, another director who is considered independent, is godfather to the second child of Lachlan Murdoch, Rupert Murdoch's eldest son.<sup>10</sup> James W. Breyer, who has

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6. Sorkin, *supra* note 3.

7. *Id.*

8. Kenneth Cowley stepped down from the board of News Corporation in September of 2011, three months after the scandal broke. Jeremy W. Peters & Matt Richtel, *News Corp. Board Undergoes a Shuffle*, N.Y. TIMES MEDIA DECODER (Sept. 2, 2011, 10:43 AM), <http://mediadecoder.blogs.nytimes.com/2011/09/02/news-corp-board-undergoes-a-shuffle/>.

9. Perkins resigned from the board of News Corporation in September of 2011. Hymowitz et al., *supra* note 5.

10. *Id.*

joined the board as a new, independent board member,<sup>11</sup> has completed several ventures with News Corporation through Accel Management, Inc., in which Breyer is a general partner; moreover, there are investments between Breyer and Rupert Murdoch's wife.<sup>12</sup> Breyer's board membership record at Wal-Mart includes several conflict-of-interest transactions, and his withdrawal from the Dell board was due to shareholder dismay at his less than 25% attendance at board meetings.<sup>13</sup> CtW Investment Group has asked, through a formal letter to Dinh, in Dinh's capacity as the Chairman of the Nominating and Corporate Governance Committee, for more comprehensive disclosure of these details about Breyer.<sup>14</sup> "Natalie Bancroft, an opera singer, was named to the board when [News Corporation] acquired Dow Jones, mainly as a way to . . . placate its former owners, the Bancrofts. Incidentally, [rejecting all other, more experienced candidates put forth by the Bancrofts,] the News Corporation picked Ms. Bancroft."<sup>15</sup>

### B. *Different Standards of Board Independence*

Despite the criticisms by mass media and shareholders about the lack of independence of the board members who News Corporation claimed were independent, these board members nominally qualify as independent under the listing requirements of NASDAQ.<sup>16</sup> One of the possible causes for the confusion may be that there are too many differing standards across varying sources, such as the standards of the stock exchanges, those imposed by federal law and enforced by the SEC, and that of Delaware state law. Furthermore, some have questioned whether the independence standard is high enough from any single one of these sources.<sup>17</sup>

#### 1. Federal Law on Board Independence

There is little federal law on board independence; however, as a reaction to the Enron accounting fraud scandal, Congress's intent in

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11. Press Release, News Corp., News Corporation Nominates Jim Breyer for Election to Board of Directors (Sept. 2, 2011), *available at* [http://www.newscorp.com/news\\_507.html](http://www.newscorp.com/news_507.html); *see also* News Corporation, Current Report (Form 8-K) (Oct. 21, 2011).

12. *See* Hymowitz et al., *supra* note 5; *see also* Letter from Richard Clayton, Research Dir., CtW Inv. Grp., to Viet D. Dinh, Chairman, News Corp. (Sept. 8, 2011), *available at* <http://www.prnewswire.com/news-releases/ctw-investment-group-questions-independence-of-new-news-corp-director-james-w-breyer-129531803.html>.

13. Letter from Richard Clayton to Viet D. Dinh, *supra* note 12.

14. *Id.*

15. Sorkin, *supra* note 3.

16. *See, e.g.,* Peters & Richtel, *supra* note 8.

17. *See infra* Parts II(B)(1)–(4).

enacting the Sarbanes–Oxley Act of 2002 (SOX) was to push public companies from managerialism towards board primacy.<sup>18</sup> Director primacy has been perceived as the most efficient resolution to the collective action problem that is generated by the complex decisions involved in managing a corporation.<sup>19</sup> Even though some have argued for shareholder primacy,<sup>20</sup> Professor Stephen M. Bainbridge has promoted director primacy instead, arguing that it is inherent in the management structure of a corporation.<sup>21</sup> Although SOX itself did not include many substantive provisions on board independence (except with regard to the audit committee), it effectuated major reforms indirectly through changes to the stock exchange listing rules implementing SOX.<sup>22</sup>

Most importantly, section 301 of SOX requires that the audit committee have the exclusive power to appoint the company auditor and that all audit committee members be independent.<sup>23</sup> Under this definition of independence, audit committee members cannot receive compensation from the company, other than board fees, and cannot be affiliates of the company or its subsidiary.<sup>24</sup> However, SOX does not provide its own definition for affiliate, as Professor Donald C. Clarke has noted.<sup>25</sup> Instead, SOX has been interpreted to have adopted the Investment Company Act of 1940's (the Investment Company Act) definition, under which anyone owning 5% or more of the company's stock is an affiliate.<sup>26</sup> Curiously enough, the Investment Company Act itself does not see stock ownership as a bar to

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18. Stephen M. Bainbridge & Christina J. Johnson, *Managerialism, Legal Ethics, and Sarbanes–Oxley Section 307*, 2004 MICH. ST. L. REV. 299, 303–06.

19. STEPHEN M. BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 155–56 (2008).

20. The loudest voices are perhaps those of shareholder activists. See generally *Ready, Set, Dough*, THE ECONOMIST (Dec. 2, 2010), <http://www.economist.com/node/17633111>.

21. BAINBRIDGE, *supra* note 19, at 200–35.

22. *Id.* at 176–87.

23. Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, § 301, 116 Stat. 745, 775–77 (codified at 15 U.S.C. § 78j-1 (2006)).

24. *Id.* This definition is fairly strict compared to, for example, NASDAQ and NYSE listing rules' general definitions of independence, which allow receipt of up to \$120,000 of consultancy fees without the director being disqualified from independence. NASDAQ OMX Grp., Inc., NASDAQ Stock Market Rules § 5605(a)(2)(A)–(B) (2012) [hereinafter NASDAQ Stock Market Rules]; NYSE Euronext, Inc., NYSE Listed Company Manual § 303A.02(b)(i)–(ii) & cmt. (2012) [hereinafter NYSE Listed Company Manual].

25. See Donald C. Clarke, *Three Concepts of the Independent Director*, 32 DEL. J. CORP. L. 73, 92 (2007).

26. *Id.* (explaining that section 301 of SOX amends section 10A of the Securities Exchange Act of 1934 (Exchange Act), and that under section 3(a)(19) of the Exchange Act, “affiliate” has the same meaning as under the Investment Company Act).

independence.<sup>27</sup> To address the confusion, the SEC has created an explicit safe harbor that a director who owns less than 10% of the company's stock does not lose independence because of such ownership.<sup>28</sup>

Section 952 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the Dodd–Frank Act) also imposes a requirement of independence on the members of the compensation committee.<sup>29</sup> The factors considered in this determination are “the source of compensation of a member of the board of directors of [a company] including any consulting, advisory, or other compensatory fee paid by the [company] to such member” and whether the director is an affiliate of the company or its subsidiary.<sup>30</sup>

## 2. SEC Disclosure Requirements Related to Board Independence

The SEC requires disclosure on proxy statements of whether each director is independent of management.<sup>31</sup> Public companies also have to disclose all categories of transactions, arrangements, and relationships that were taken into account in the independence determination,<sup>32</sup> but law professor J. Robert Brown, Jr. has critically remarked that requiring the disclosure of merely the categories of relationships is not enough and that disclosure of the relationships themselves should be required instead.<sup>33</sup> Brown's criticism is similar to the concerns expressed by CtW Investment Group in its letter regarding the disclosure of investments between Breyer (or his company) and News Corporation (or the Murdoch family). Even if the investments had

27. See 15 U.S.C. § 80a-2(a)(3), (a)(19)(A).

28. Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8,220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 68 Fed. Reg. 18,788, 18,793 (Apr. 16, 2003).

29. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 952, 124 Stat. 1376, 1900 (2010) (codified at 15 U.S.C.A. § 78j-3 (West 2010)).

30. *Id.* § 952(a)(3)(A). Even though section 301 of SOX provides a clear and strict definition for the independence of audit committee members, the Dodd–Frank Act merely sets these two parameters—fees and affiliation—to consider in defining the independence of nominating committee members. See Listing Standards for Compensation Committees, Securities Act Release No. 9,199, Exchange Act Release No. 64,149, 77 Fed. Reg. 38,422, 38,427 (June 27, 2012). This leaves the stock exchanges with discretion to adopt their own definition of independence for nominating committee members. *Id.* The Investment Company Act and the Internal Revenue Code have their own independence requirements, but those are outside of the scope of this Article.

31. 17 C.F.R. § 229.407(a) (2012).

32. *Id.*

33. J. Robert Brown Jr., *The NYSE and the Problems of Director Independence: The Need for SEC Reform (Part 4)*, THE RACETO THE BOTTOM.ORG (June 2, 2010, 9:00 AM), <http://www.the-racetothetobottom.org/independent-directors/2010/6/2/the-nyse-and-the-problems-of-director-independence-the-need.html>.

fallen under the categories considered by the board in the determination of the independence of Breyer, News Corporation would have been allowed to leave out the details from the public filings.

Those in favor of more scant disclosure could respond, however, that disclosing actual relationships that were deemed immaterial would defeat the purpose of limiting disclosure to only material relationships because all relationships that were even considered would then be disclosed. The backfire would be a more limited evaluation of different factors by the board to avoid automatically subjecting all evaluated relationships to disclosure.

Further disclosure required by the SEC rules includes disclosure of any interlocking directors; namely, whether any of the executives of the company serve on the compensation committee of another company and whether that company has any executives that serve on the compensation committee of the disclosing company.<sup>34</sup>

Additionally, the SEC can bring an enforcement action against a company for false or misleading disclosures. As a part of such an enforcement action, the SEC also wields the measure of seeking an injunction to bar a given director from serving on corporate boards of any public company during a specific number of years.<sup>35</sup> For example, the SEC imposed a five-year ban on Martha Stewart as a part of her settlement of the insider trading charges brought against her.<sup>36</sup>

### 3. Independence Under Stock Exchange Listing Standards

The stock exchanges, too, have reacted to Congress's intent to increase director primacy by giving more power to independent directors in at least two ways. First, independent directors have to meet regularly without inside directors in so-called executive sessions.<sup>37</sup> The official comments to the NASDAQ listing rules suggest that such

34. 17 C.F.R. § 229.407.

35. See Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, § 201(2), 104 Stat. 931, 935–36 (codified as amended at 15 U.S.C. § 78u(d) (2006)) (adding section 20(e) to the Securities Act of 1933 and section 21(d)(2) to the Exchange Act). These sections provide that, in any case of willful or reckless fraud, a court may prohibit a person from acting as an officer or director of a public company—“conditionally or unconditionally, and permanently or for such period of time as it shall determine”—but only upon a showing of “substantial unfitness” to serve as an officer or director. *Id.*

36. See Shira Ovide, *Martha Stewart Is Out of SEC Jail*, WALL ST. J. DEAL J. (Sept. 26, 2011, 9:27 AM), <http://blogs.wsj.com/deals/2011/09/26/marth-stewart-is-out-of-sec-jail/>; Press Release, U.S. Sec. & Exch. Comm'n, Martha Stewart and Peter Bacanovic Settle SEC's Insider Trading Charges (Aug. 7, 2006), available at <http://www.sec.gov/news/press/2006/2006-134.htm>.

37. NASDAQ Stock Market Rules, *supra* note 24, § 5605(b)(2); NYSE Listed Company Manual, *supra* note 24, § 303A.03.

sessions should be held at least twice a year.<sup>38</sup> The comments to the NYSE listing rules suggest once a year.<sup>39</sup> However, the “emerging best practice,” as Bainbridge has remarked, is to hold such a session in connection with every regular board meeting.<sup>40</sup> Second, both NYSE and NASDAQ require—in addition to the independent audit committee members per SOX—that the members of the nominating committee and the compensation committee also be independent.<sup>41</sup>

The NASDAQ and NYSE listing standards are, for the most part, overlapping in their requirements of director independence; therefore, the subsections below discuss them in parallel, pointing out the parts where the rules differ.

#### a. General Definition of Independence

Pre-Enron, the NYSE and NASDAQ listing rules required that a board have at least three independent directors.<sup>42</sup> Now, the listing rules of both stock exchanges require that the majority of the board consist of independent directors.<sup>43</sup> At the start of the scandal, News Corporation reported that nine of sixteen directors were independent.<sup>44</sup> The company counted Cowley, Dinh, Breyer, and Bancroft among the nine, despite their connections to News Corporation, Rupert Murdoch, or his family members.<sup>45</sup> Whereas the rules of NASDAQ (on which News Corporation is listed) state in merely general terms that “Independent Director means a person” who does not have “a relationship which . . . would interfere with the exercise of indepen-

38. NASDAQ Stock Market Rules, *supra* note 24, § 5605(b)(2) & IM-5605-2.

39. NYSE Listed Company Manual, *supra* note 24, § 303A.03 & cmt.

40. BAINBRIDGE, *supra* note 19, at 178.

41. See NASDAQ Stock Market Rules, *supra* note 24, § 5605(d)–(e); NYSE Listed Company Manual, *supra* note 24, § 303A.04(a), 05(a). The NASDAQ rules do not require listed companies to have a compensation committee, but the NYSE rules do. NASDAQ Stock Market Rules, *supra* note 24, § 5605(d) & IM-5605-6. Under the NASDAQ rules, if a company does not have a compensation committee, the applicable independence requirements apply to the whole board. *Id.* § 5615(c)(2). An exception to the requirement of having an entirely independent compensation committee and nomination committee (or the equivalent group of independent directors under NASDAQ) is made for controlled companies. *Id.* § 5615(c) & IM-5615-5. They are not required to have independent directors in their compensation and nominating committees, but are required to have independent audit committees. See *id.* § 5615(c)(2); NYSE Listed Company Manual, *supra* note 24, § 303A.00.

42. DIANE E. AMBLER ET AL., *SARBANES–OXLEY ACT: PLANNING & COMPLIANCE* § 5.02[D][2][a] (2005 & Supp. 2008).

43. NASDAQ Stock Market Rules, *supra* note 24, § 5605(b)(1); NYSE Listed Company Manual, *supra* note 24, § 303A.01.

44. Sorkin, *supra* note 3.

45. *Id.*



dent judgment in carrying out the responsibilities of a director,”<sup>46</sup> NYSE goes into more detail by defining that a director is considered independent if he has no material relationship with the company, taking into account “commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others.”<sup>47</sup> Under both sets of rules, the board has to take into account any persons and organizations with which the director is affiliated—besides considering the director personally.<sup>48</sup> Also, the board itself makes the determination of independence, to the chagrin of Brown as discussed in Part II(B)(2).<sup>49</sup>

Both sets of listing rules make an exception to the majority independence requirement in the case of companies with a controlling shareholder.<sup>50</sup> As Clarke has noted, this shows that the exchanges view independence as a protection of the shareholders from management.<sup>51</sup> Even though News Corporation has a dual-class stock structure and the Murdoch family trust owns 38% of the voting shares,<sup>52</sup> News Corporation does not qualify for the exemption because, according to the NASDAQ listing rules, only shareholders who have more than 50% of the voting power for the election of directors—either as an individual or as a group—count as a controlling shareholder.<sup>53</sup>

Brown has criticized the stock exchange listing rule definitions of independence because they focus on the director’s relationship with the company without capturing the director’s relationships with management.<sup>54</sup> For example, in the merger of Black & Decker and Stanley Works, an independent committee approved a hefty post-merger compensation package to the CEO, including, for example, a \$45 mil-

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46. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2) (internal quotation marks omitted).

47. NYSE Listed Company Manual, *supra* note 24, § 303A.02(a) & cmt.

48. *See id.*; NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2) & IM-5605.

49. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a) & IM-5605 (“The board has a responsibility to make an affirmative determination that no . . . relationships [that would impair the board’s independence] exist . . . .”); NYSE Listed Company Manual, *supra* note 24, § 303A.02(a) (“No director qualifies as ‘independent’ unless the board of directors affirmatively determines that the director has no material relationship with the listed company.”).

50. *See* NASDAQ Stock Market Rules, *supra* note 24, § 5615(c)(2); NYSE Listed Company Manual, *supra* note 24, § 303A.00.

51. *See* Clarke, *supra* note 25, at 93–94.

52. *See* Sorkin, *supra* note 3.

53. NASDAQ Stock Market Rules, *supra* note 24, § 5615(c) & IM-5615-5.

54. *See* J. Robert Brown Jr., *The NYSE and the Problems of Director Independence: The Plain Meaning of NYSE 303A.02 (Part 2)*, [THE RACE TO THE BOTTOM.ORG](http://www.theracetothetbottom.org/independent-directors/2010/6/1/the-nyse-and-the-problems-of-director-independence-the-plain.html) (June 10, 2010, 9:00 AM), <http://www.theracetothetbottom.org/independent-directors/2010/6/1/the-nyse-and-the-problems-of-director-independence-the-plain.html>.

lion synergy bonus.<sup>55</sup> Curiously enough, the CEO, who was the beneficiary of the package, also participated in the decision of nominating the members of the independent committee that approved the package.<sup>56</sup> Furthermore, one of the committee members had an outside business relationship with the CEO related to a \$200 million project developing a luxury recreational community.<sup>57</sup> None of these facts were subject to mandatory disclosure under the stock exchange rules.

When faced with these facts, Black & Decker issued a press release explaining why it had not disclosed the outside business relationships in its public filings, explaining that “[p]ersonal business relationships between individuals (as opposed to relationships with the company) generally are not relevant to the independence tests under the [NYSE] rules because they do not create a material relationship between a director and the company.”<sup>58</sup> Even though Black & Decker’s statement seems like an accurate description of the NYSE listing requirements, representatives of NYSE intervened and advised Black & Decker that such relationships would, in fact, have to be taken into account in the determination of independence.<sup>59</sup> The seeming conflict between this statement by the NYSE and the wording of its listing rules (and the official comments thereto) creates some unclarity as to what exactly has to be disclosed.<sup>60</sup>

In *SEC v. Krantz*, the SEC challenged the independence of the audit committee members who were personal friends of the CEO (a long-time neighbor, a family friend who regularly attended family social functions, and a long-term friend and insurance agent).<sup>61</sup> Under

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55. Joann S. Lublin, *Black & Decker CEO Stands to Get Big Payday*, WALL. ST. J. (Mar. 10, 2010), <http://online.wsj.com/article/SB10001424052748704145904575112023406207574.html?KEYWORDS=black+and=decker>.

56. *Id.*

57. *Id.*

58. Press Release, Black & Decker, Black & Decker Provides Additional Information in Connection with the Special Meetings of Stockholders to Consider the Stanley Transaction (Mar. 9, 2010), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=114416&p=irol-bdknewsArticle&ID=1408428&highlight=>.

59. Even though NYSE did not make its statement in public, Black & Decker released another statement the day after its initial statement that revealed the NYSE’s view. Press Release, Black & Decker, Black & Decker Issues Further Statement in Connection with the Special Meetings of Stockholders to Consider the Stanley Transaction (Mar. 10, 2010), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=114416&p=irol-bdknewsArticle&ID=1408429&highlight=>.

60. See Colin J. Diamond, *Director–Management Relationships Under Stock Exchange Independence Standards*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Apr. 4, 2010, 9:22 AM), <http://blogs.law.harvard.edu/corpgov/2010/04/04/director-management-relationships-under-stock-exchange-independence-standards/>.

61. Complaint, *SEC v. Krantz*, Civil Action No. 0:11-cv-60432 (S.D. Fla. 2011), available at <http://www.sec.gov/litigation/complaints/2011/comp21867-directors.pdf>.

the stock exchange listing rules, all of the three directors could, however, be considered independent.

At least Martin Lipton of Wachtell, Lipton, Rosen & Katz has not found it problematic to have friends of the CEO count as independent directors for the stock exchange majority independence requirement.<sup>62</sup> According to Lipton, "There is absolutely no basis for second-guessing a board's reasonable determination that a friend of the CEO, or a friend of another director, is independent."<sup>63</sup> Lipton, along with his colleagues, notes that the "concept of directors as remote strangers and the board as primarily an agency for the discipline of management, rather than as an advisor to management in setting the strategic course of the corporation, is contrary to all prior experience and will not lead to better performance."<sup>64</sup> Brown has noted that if friends of the CEO were so irreplaceable because of their special skills, they could well serve as non-independent directors.<sup>65</sup>

#### b. Employment or Compensation by the Company

The NASDAQ and NYSE rules provide some clear-cut guidance that a person who has been employed as an executive or a non-executive employee by the company or its parent or consolidated subsidiary during the prior three years can never be considered independent.<sup>66</sup> Neither can a director who has received (or whose family member has received) non-director compensation—e.g. consultancy, legal or accounting fees, etc.—from the company (or its parent or consolidated subsidiary) in excess of \$120,000 during any twelve-month period during the three years prior to the nomination.<sup>67</sup> The \$120,000 limit does not, however, include director's fees.<sup>68</sup> Brown has criticized the stock

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62. Martin Lipton, *Corporate Governance Adrift*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 18, 2011, 11:34 AM), <http://blogs.law.harvard.edu/corpgov/2011/03/18/corporate-governance-adrift/>.

63. *Id.*

64. Memorandum from Martin Lipton et al., Partners, Wachtell, Lipton, Rosen & Katz, Some Thoughts for Boards of Directors in 2010 18 (Nov. 30, 2009), available at <http://www.wlrk.com/docs/thoughtsfordirectors2010.pdf>.

65. J. Robert Brown Jr., *Directors and FOCs (Friends of CEO)*, THE RACETOTHEBOTTOM.ORG (Mar. 19, 2011, 6:00 AM), <http://www.theracetothetbottom.org/independent-directors/directors-and-focs-friends-of-ceo.html>.

66. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(A); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(i).

67. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(ii).

68. See NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B)(i); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(ii). The \$120,000 limit also does not include compensation to a family member of the director who is a non-executive employee of the company. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B)(ii); NYSE Listed Company Man-

exchange rules for not counting the director's fees in setting the threshold for independence;<sup>69</sup> however, it is important to note that meeting one of the bright-line rules does not necessarily mean that the director is independent.<sup>70</sup> The board still has to evaluate the director's independence under the general NYSE or NASDAQ independence test.<sup>71</sup>

### c. Relationship with the Company Auditor

Under the NYSE rules, a director is not independent if she is a current employee or partner at the company's internal or external auditor.<sup>72</sup> In this respect, the NYSE rules are stricter than the corresponding NASDAQ requirement, under which an affiliation with the outside auditor disqualifies the director but affiliation with the inside auditor does not.<sup>73</sup>

### d. Stock Ownership

Under the NASDAQ rules, ownership of the company stock does not, in and of itself, preclude a board's finding of independence.<sup>74</sup> The NYSE rules explain that "even a significant" stock ownership

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ual, *supra* note 24, § 303A.02(b)(ii) & cmt. The mere fact that the director's family member has been an employee of the company does not strip the director of independence, even if such family member received more than \$120,000 in regular employment compensation. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B)(ii); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(ii) & cmt. On the other hand, a family member having received compensation as an executive or consultant will count towards the \$120,000 limit. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B)(ii); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(ii) & cmt. Tax-qualified retirement benefits do not count towards the \$120,000 either. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(B)(iii); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(ii). Under the NASDAQ and NYSE rules, being an interim executive officer does not disqualify a director from being independent after the interim period has ended unless it lasted for more than a year. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a) & IM-5605; NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(i) & cmt.

69. See Brown, *supra* note 33.

70. See Executive Compensation and Related Party Disclosure, 71 Fed. Reg. 6,542, 6,572 n.239 (proposed Feb. 8, 2006).

71. See *id.*

72. NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(iii)(A). Also, a director is not independent if her immediate family member is a current partner at the company's internal or external auditor. *Id.* § 303A.02(b)(iii)(B). Similarly, if a family member of a director is a current employee of the company's internal or external auditor and personally works on the company audit, the director is not independent. *Id.* § 303A.02(b)(iii)(C). Even if a director or a family member of the director was an employee or a partner at the company's internal or external auditor within the preceding three years and personally worked on the company audit during that time, the director is not independent. *Id.* § 303A.02(b)(iii)(D).

73. See NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(F).

74. *Id.* § 5605(a) & IM-5605.

does not bar a finding of independence because the independence of a director is independence from management rather than from the company as a whole.<sup>75</sup> As scholar-practitioner Bruce F. Dravis has noted, this seems to be in conflict with the wording of the general rule that a director's relationships with only the company, and not, for example, personal relationships with managers, are considered in evaluating independence.<sup>76</sup>

The fact that the stock exchanges do not consider stock ownership as prohibiting independence shows that their concept of independence differs from the one put forth by the SEC.<sup>77</sup> Under the SEC's definition, independent directors should not have ties to the shareholders or management; the stock exchanges, in contrast, perceive it as a good thing that independent directors own stock and that their and the stockholders' interests are aligned.<sup>78</sup>

#### e. Transactions with the Company

Under the NYSE rules, a current employee or executive officer of another company (or the family member of a current executive officer of another company) cannot be an independent director of a listed company if that other company has had a significant transaction with the listed company within the preceding three fiscal years.<sup>79</sup> A transaction is considered significant if the value "exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues."<sup>80</sup> The corresponding NASDAQ rule requires that:

[A] director [not be] . . . a partner in, or a controlling Shareholder or an Executive Officer of, any organization to which the Company made, or from which the Company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more.<sup>81</sup>

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75. NYSE Listed Company Manual, *supra* note 24, § 303A.02(a) & cmt.

76. See BRUCE F. DRAVIS, THE ROLE OF INDEPENDENT DIRECTORS IN CORPORATE GOVERNANCE 16 (2010).

77. Clarke, *supra* note 25, at 93-94.

78. *Id.* When the SEC implemented SOX, it put forth the safe harbor provision allowing directors who own no more than 10% of company stock to be independent. See *supra* Part II(B)(1).

79. NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(v).

80. *Id.*

81. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(D)(i)-(ii). For example, the outside legal counsel of a company could qualify as an independent director on the board of the company as long as her legal fees do not exceed \$120,000 if the attorney is in a sole proprietorship, see *supra* Part II(B)(3)(b), or 5% or \$200,000, if the attorney is in a law firm. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a) & IM-5605. Such an attorney could not, however, serve on the audit committee. *Id.*

Breyer seems to have a history of violating this requirement.<sup>82</sup> His company, Accel Management, Inc., engaged in a joint venture with Wal-Mart to spin off walmart.com in 2000;<sup>83</sup> later, in 2011, Wal-Mart purchased Kosmix, Inc. from Accel and other investors for a reported \$300 million.<sup>84</sup> During all of this, Breyer was on the Wal-Mart board as an independent director.<sup>85</sup> This example shows how lack of action by NASDAQ or the NYSE against violations of listing requirements renders the requirements nearly toothless.

The significant transaction rule does not apply to purchases of company stock.<sup>86</sup> Presumably, News Corporation's acquisition of Dow Jones from the Bancrofts would not render Natalie Bancroft non-independent as a director of News Corporation in the eyes of NASDAQ.<sup>87</sup>

#### f. Compensation Committee Interlocks

Under both the NYSE and NASDAQ rules, an interlocking director cannot be considered independent until three years after the director's employment or service as executive at the other company has ended.<sup>88</sup>

#### g. Charity

Under the NASDAQ rules, the amounts for charitable donations correspond to those for business transactions.<sup>89</sup> The NYSE, in contrast, does not apply the same test to charitable relationships as to business relationships, and charitable contributions never lead to automatic disqualification. Instead, the board has to consider charitable

82. Letter from Richard Clayton to Viet D. Dinh, *supra* note 12.

83. *See id.*

84. *Id.*; *see also* Ty McMahan, *Will Wal-Mart's Kosmix Deal Inspire Other Retailers?*, WALL ST. J. (Apr. 20, 2011, 2:39 PM), [http://blogs.wsj.com/venturecapital/2011/04/20/wal-marts-kosmix-deal-may-inspire-other-retailers/?mod=google\\_news\\_blog](http://blogs.wsj.com/venturecapital/2011/04/20/wal-marts-kosmix-deal-may-inspire-other-retailers/?mod=google_news_blog); Chris V. Nicholson, *Wal-Mart Buys Social Media Firm Kosmix*, N.Y. TIMES DEALBOOK (Apr. 19, 2011, 4:36 AM), <http://dealbook.nytimes.com/2011/04/19/wal-mart-buys-social-media-site-kosmix/>.

85. *See James Breyer*, FORBES, <http://people.forbes.com/profile/james-w-breyer/51425> (last visited Mar. 4, 2013) (stating that Breyer has served as an independent director on Wal-Mart's board since 2001); Wal-Mart Stores, Inc., Definitive Proxy Statement (Schedule 14A) (Apr. 14, 2006).

86. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(D)(i).

87. *See id.*

88. *Id.* § 5605(a)(2)(E); NYSE Listed Company Manual, *supra* note 24, § 303A.02(b)(iv). The SEC rules define "interlocking director." *See supra* Part II(B)(2).

89. A donation in excess of \$200,000 or 5% of a charity's gross revenue by a listing company leads to automatic disqualification of the charity's executive from being an independent board member on the donating listing company's board. NASDAQ Stock Market Rules, *supra* note 24, § 5605(a)(2)(D)(ii) & IM-5605.

relationships as part of the general director independence consideration.<sup>90</sup>

#### h. Consequences of Noncompliance

The CEO has to personally certify that a listed company is in compliance with the independence standard.<sup>91</sup> Prior to January 1, 2010, the CEO had the obligation to disclose any material noncompliance with the independence standard. Since then, the disclosure requirement was elevated to include *any* noncompliance.<sup>92</sup> Such a disclosure has to be made in company proxy statements.<sup>93</sup>

The enforcement of the NYSE and the NASDAQ independence requirements is indirect: listed companies must make accurate disclosure as to whether they are in compliance with the rules.<sup>94</sup> If a company's disclosure is misleading, it may face liability for violations of the federal securities laws. In cases where the disclosure was incorrect due to genuine error, however, it is not clear what the sanction would be other than the shaming mechanism targeting the company's CEO, as Clarke has noted.<sup>95</sup>

### 4. Board Independence Under Delaware Law

Notwithstanding the concerns of Clarke, as far as substantive law is concerned, the most progressive independence reforms have come from the changes to proxy disclosure requirements and to the stock exchange listing rules, as Professor Myles L. Mace noted in 1979.<sup>96</sup> In fact, this still held true in 2011—the independence requirements put forth by the stock exchanges and the proxy disclosure requirements are way ahead of state law on this topic.

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90. See NYSE Listed Company Manual, *supra* note 24, § 303A.02(a) & cmt. In addition, companies must disclose charitable contributions exceeding \$1 million or 2% of the organization's gross revenues if an independent director of the company served as an officer of the organization. *Id.* § 303A.02(a) & Disclosure Requirement ("The listed company must comply with the disclosure requirements set forth in Item 407(a) of Regulation S-K.").

91. See NASDAQ Stock Market Rules, *supra* note 24, § 5625; NYSE Listed Company Manual, *supra* note 24, § 303A.12.

92. This was a change imposed by federal law to reflect the change in Item 407(a) of Regulation S-K. NYSE Listed Company Manual, *supra* note 24, § 303A.12(a) ("Each listed company CEO must certify to the NYSE each year that he or she is not aware of any violation by the listed company of NYSE corporate governance listing standards, qualifying the certification to the extent necessary.").

93. 17 C.F.R. § 229.407(a) (2012).

94. See *supra* notes 91–93.

95. Clarke, *supra* note 25, at 88–89.

96. See Myles L. Mace, *Directors: Myth and Reality—Ten Years Later*, 32 RUTGERS L. REV. 293, 298–302 (1979).

While state law imposes no general independence requirement on board members, the interpretation of the monitoring board institution by the Delaware courts provides directors with almost complete protection from liability, as Professor Lawrence E. Mitchell has noted.<sup>97</sup> Thus, the board has a high incentive to strive for independence.<sup>98</sup>

Independence is particularly relevant in conflict-of-interest transactions because approval of such a transaction by disinterested board members gives the transaction the protection of the business judgment rule.<sup>99</sup> In this context, the more accurate term is “disinterestedness,” which refers to the lack of director financial interest in the specific transaction.<sup>100</sup> Independence, in contrast, means that the director, even though not personally interested, is also not “dominated or controlled by a materially interested director.”<sup>101</sup>

Under Delaware state law, under which most public companies are incorporated, board independence is a highly fact-driven inquiry.<sup>102</sup> According to the Delaware Supreme Court, “Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.”<sup>103</sup> The courts inquire:

[W]hether the director’s decision resulted from that director being *controlled* by another. A director can be controlled by another if in fact he is *dominated* by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is *beholden* to the allegedly controlling entity. A director may be considered beholden to (and thus controlled by) another when the

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97. Lawrence E. Mitchell, *The Trouble with Boards*, in PERSPECTIVES ON CORPORATE GOVERNANCE 17, 54–58 (F. Scott Kieff & Troy A. Paredes eds., 2010). For a discussion on the “monitoring board” institution, see *infra* Part III.

98. BAINBRIDGE, *supra* note 19, at 175–76.

99. See DEL. CODE ANN. tit. 8, § 141(a) (2012) (“No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason.”).

100. Clarke has attempted to clarify the discourse on board independence by distinguishing from independence two other concepts, “outside director” and “disinterested director,” which are sometimes used interchangeably with “independent director,” but refer to a narrower category of directors. Clarke, *supra* note 25, at 99–102. Clarke explains that outside director means a director who is not a company employee. *Id.* at 100. This concept is widely used under German, U.K., and Japanese corporate law, but it has no use under U.S. law. *Id.* Disinterested director, in turn, refers to a director who does not have a financial interest in the transaction in question. *Id.* at 102–04.

101. Orman v. Cullman, 794 A.2d 5, 22 (Del. Ch. 2002).

102. Beam *ex rel.* Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1049 (Del. 2004).

103. Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984).



allegedly controlling entity has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively.<sup>104</sup>

Under *McMullin v. Beran*, director independence is evaluated under "a subjective actual person standard to determine whether a given director was likely to be affected in the same or similar circumstances."<sup>105</sup> "To establish that a *board* . . . lacked independence, a plaintiff must allege facts as to the . . . lack of independence of the *individual members* of that board."<sup>106</sup> The key to the plaintiff's success is to point to specific details that have resulted in the director's beholdenness rather than to make conclusory allegations;<sup>107</sup> the plaintiff has to plead the lack of independence with specificity under Federal Rule of Civil Procedure 23.1.<sup>108</sup>

#### a. Controlling Shareholders and Dominating Company Founders

In *Aronson v. Lewis*, a case involving a 47% shareholder, the Delaware Supreme Court explained that less-than-majority stock ownership can never prove lack of independence and that even majority stock ownership cannot, in the pre-suit demand context, prove lack of independence without additional evidence of personal or other relationships.<sup>109</sup> Because the Murdoch family has less than half of the voting power, its ownership would not suffice for disproving independence in a pre-suit demand.<sup>110</sup>

The Delaware courts have taken a similar position toward company founders. In *Apple Computer, Inc. v. Exponential Technology, Inc.*, independence of a director was not put into doubt by the fact that he was a co-founder of the company even though he had to consider a demand to sue another co-founder.<sup>111</sup> In *Jacobs v. Yang*, the Dela-

104. *Orman*, 794 A.2d at 25 n.50.

105. *McMullin v. Beran*, 765 A.2d 910, 923 (Del. 2000) (internal quotation marks omitted).

106. *Orman*, 794 A.2d at 22.

107. *Beam*, 845 A.2d at 1050.

108. FED. R. CIV. P. 23.1(b)(3) ("The complaint must be verified and must *state with particularity* any effort by the plaintiff to obtain the desired action from the directors or comparable authority and, if necessary, from the shareholders or members; and the *reasons for not obtaining the action or not making the effort.*" (emphasis added)).

109. *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

110. *Sorkin*, *supra* note 3.

111. *Apple Computer, Inc. v. Exponential Tech., Inc.*, No. 16315, 1999 WL 39547, at \*12 (Del. Ch. Jan. 21, 1999).

ware Chancery Court did not find a director incapable of considering a demand to sue two founders of the company even though the existence of the company allegedly depended on those founders.<sup>112</sup>

Surprisingly, the mere existence of a controlling shareholder who is also chairman of the board and an executive does not create an assumption that she would lack independence unless the plaintiff is able to show other relationships between the directors and the controlling shareholder.<sup>113</sup> In *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, Stewart had 94% of the voting power of the company, but the Delaware Supreme Court did not think that this would have sufficed for lack of independence to consider the pre-suit demand, even in combination with facts that established a personal friendship between the directors and Stewart.<sup>114</sup> It would seem that much of the presumed questionability posed by Sorkin as to the independence of the News Corporation directors, based on their friendship with Rupert Murdoch, would not hold up in a Delaware court, at least in the context of a pre-suit demand.

#### b. Mere Approval of Transaction or Customary Board Fees Do Not Suffice

It is also clear that the mere fact that the director took part in an approval of a transaction that is contested by a shareholder in a suit is not sufficient to make the case for lack of independence.<sup>115</sup> For example, in *Aronson*, the directors had approved an employment contract that did not make the compensation contingent on the employee's ability to perform services to the company.<sup>116</sup> A shareholder challenged the contract as waste of corporate assets, asserting that demand was futile.<sup>117</sup> According to the shareholder, the directors lacked independence because they themselves had approved the contract.<sup>118</sup> The Delaware Supreme Court held that the same directors could validly make the decision as to how to respond to the shareholder demand to bring a lawsuit against them.<sup>119</sup> This was because the plaintiff

112. *Jacobs v. Yang*, No. Civ.A. 206-N, 2004 WL 1728521, at \*6 (Del. Ch. Aug. 2, 2004), *aff'd*, 867 A.2d 902 (Del. 2005).

113. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1054 (Del. 2004) (discussing the 94% shareholder, Martha Stewart).

114. *Id.*

115. *See Aronson v. Lewis*, 473 A.2d 805, 817 (Del. 1984); *Cal. Pub. Emps.' Ret. Sys. v. Coulter*, No. Civ.A. 19191, 2002 WL 31888343, at \*8 (Del. Ch. Dec. 18, 2002).

116. *See Aronson*, 473 A.2d at 808–09.

117. *Id.* at 809–10, 817–18.

118. *See id.* at 817–18.

119. *Id.*

had not sufficiently pled a breach of fiduciary duty claim.<sup>120</sup> Presumably, the case would have come out differently if the plaintiff had succeeded in making the case that the approval of the contract, in fact, constituted a waste of corporate assets by the directors.

Also, a director does not lose her independence merely because she has received fees for sitting on the board. As the Delaware Chancery Court articulated in *Orman v. Cullman*, as long as the fees are within the range of "usual and customary," a director will not lose her independence.<sup>121</sup> In *Security Police & Fire Professionals of America Retirement Fund v. Mack*, a New York state court, discussing demand futility, found that yearly board fees ranging from \$325,000 to \$376,733 were, on their face, customary, and that the plaintiffs failed to rebut the presumption of independence because they did not prove otherwise.<sup>122</sup> On the other hand, in *In re National Auto Credit*, a massive increase in directors' fees in return for the directors' support of certain agreements raised reasonable doubt about the directors' independence.<sup>123</sup> Similarly, in *Kahn v. Portnoy*, a director's independence was put into question because he had also received payment as the trustee of an investment trust controlled by another director.<sup>124</sup>

In *Jacobs v. Yang*, the court explained that even though the director stock option plan in place for the Yahoo directors may have amounted to "substantial remuneration" of the directors, the nominating committee, which was in charge of nominating candidates for continued board membership, consisted of other independent directors.<sup>125</sup> Because the founders of the company, to which the independent directors were allegedly beholden, were not in charge of the continued board tenure of the independent directors, even substantial board fees could not strip the directors of their independence.<sup>126</sup>

### c. Personal Friendship and Familial Ties

If the cause of the lack of independence is personal friendship, the Delaware courts seem to be reluctant to find a lack of independence

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120. *Id.*

121. *Orman v. Cullman*, 794 A.2d 5, 29 n.62 (Del. Ch. 2002).

122. *Sec. Police & Fire Prof'ls of Am. Ret. Fund v. Mack*, 917 N.Y.S.2d 527, 541 (N.Y. App. Div. 2010), *appeal dismissed*, 940 N.Y.S.2d 609 (N.Y. App. Div. 2012).

123. *See In re Nat'l Auto Credit Inc. S'holders Litig.*, No. Civ.A. 19028, 2003 WL 139768, at \*8-9 (Del Ch. Jan. 10, 2003) (noting that the court perceived that increase in the directors' fees stripped the directors of their disinterestedness rather than their independence, which demonstrates, however, that the two concepts often overlap).

124. *See Kahn v. Portnoy*, No. 3515-CC, 2008 WL 5197164, at \*11-13 (Del. Ch. Dec. 11, 2008).

125. *Jacobs v. Yang*, No. Civ.A. 206-N, 2004 WL 1728521, at \*4 (Del Ch. Aug. 2, 2004).

126. *See id.* at \*3-4.

even in the most extreme cases, at least if the case does not involve independence of a special litigation committee. To establish lack of independence, personal friendship has to “border on . . . familial loyalty and closeness.”<sup>127</sup> In *Stewart*, where the Delaware Supreme Court evaluated director independence to consider a pre-suit demand, the directors and Stewart were part of “the same social circles, attended the same weddings, developed business relationships before joining the board, and described each other as friends.”<sup>128</sup> Specifically, the plaintiff showed that one of the directors had attended Stewart’s lawyer’s daughter’s wedding reception along with Stewart and that *Fortune* had published an article focusing on the close personal relationships between the directors and Stewart.<sup>129</sup> Still, the Delaware Supreme Court found that all of this was not enough to rebut the presumption of independence.<sup>130</sup> The court explained “[t]hat a much stronger relationship is necessary to overcome the presumption of independence at the demand futility stage.”<sup>131</sup> This rule is “especially compelling when one considers the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct.”<sup>132</sup> The court seems to believe that directors sufficiently fear lawsuits for breaches of fiduciary duty to set aside their loyalty to a personal friend.

In *In re J.P. Morgan Chase*, the Delaware Chancery Court explained that even though a director’s son was employed by the company, this did not make the director lose his independence because the director’s son was not an executive officer of the company and also did not live in the same household as the director.<sup>133</sup>

#### d. Merger Approval

The analysis of board independence in the context of a merger approval is slightly more practical. Besides making the determination of individual board member independence, the courts investigate whether the board *actually* acted in an independent manner. In *Kahn v. Lynch Communication Systems*, a special committee had been set up to consider the merger of the company to another company, which

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127. *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1050 (Del. 2004).

128. *Id.* at 1051 (internal quotation marks omitted).

129. *Id.* at 1045.

130. *Id.* at 1051.

131. *Id.* at 1052.

132. *Beam*, 845 A.2d at 1052.

133. *In re J.P. Morgan Chase & Co. S’holder Litig.*, 906 A.2d 808, 823 (Del. Ch. 2005), *aff’d*, 906 A.2d 766 (Del. 2006).

was also its controlling shareholder.<sup>134</sup> The Delaware Supreme Court found that the special committee was not independent for two reasons. First, the committee's mandate was unclear—it did not have the full power to conduct the negotiations independently. Second, the committee did not have real bargaining power to say no to the offer made by the controlling shareholder because of the threat made by the controlling shareholder of a hostile tender offer.<sup>135</sup>

#### e. Business Relationships and Charitable Relationships

According to the Delaware Supreme Court, “Allegations of . . . a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence” in the demand futility context.<sup>136</sup> The Delaware Chancery Court, for its part, has held, also in the context of demand futility, that a material business relationship with another company with which a director is affiliated cannot result, generally, in the director's losing her independence.<sup>137</sup> The exception arises if the specific manager, to whom the director is allegedly beholden, exercises control over the company or its relationship with the other company with which the director is affiliated.<sup>138</sup> Also, the materiality threshold requires that the plaintiff does more than merely allege that the substantial viability of the director's affiliate company depends on the business relationship.<sup>139</sup>

In *In re J.P. Morgan Chase*, the Delaware Chancery Court also found, in the context of demand futility, that a director's stock ownership in a large corporation, of which the director was the former CEO, was not enough to establish that the director was not independent.<sup>140</sup> As to charitable relationships, the court held that the plaintiff has to show a connection between the director and the charitable contribution beyond the director's sitting on the board of the charity that has received contributions from the company.<sup>141</sup>

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134. *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1112–13 (Del. 1994).

135. *Id.* at 1118–20.

136. *Beam*, 845 A.2d at 1050.

137. *See, e.g., In re J.P. Morgan Chase*, 906 A.2d at 822–23.

138. *See, e.g., id.* at 822.

139. *Jacobs v. Yang*, No. Civ.A. 206-N, 2004 WL 1728521, at \*5–6 (Del. Ch. Aug. 2, 2004).

140. *See In re J.P. Morgan Chase*, 906 A.2d at 820–22.

141. *Id.* at 822.

f. Independence of a Special Litigation Committee

In the context of a special litigation committee, the threshold for independence is perhaps the highest.<sup>142</sup> However, the court must be provided with specific facts to draw the conclusion that a specific committee member is not independent—mere conclusory statements by the director that “[t]hose that got most of the gold make most of the rules” do not suffice.<sup>143</sup>

In *Lewis v. Fuqua*, the defendant failed to show that the special litigation committee was independent.<sup>144</sup> Although he did not participate in the decision itself, the single member of the committee was a board member when the challenged board action took place.<sup>145</sup> This member was, in fact, also a defendant in the pending lawsuit.<sup>146</sup> In addition, the member had numerous political and financial dealings with the CEO who allegedly controlled the board.<sup>147</sup> The member was also president of Duke University, which had recently received a \$10 million contribution from the company.<sup>148</sup> The CEO was also a trustee of the university and had made several personal contributions to the university in the past.<sup>149</sup>

In *In re Oracle*, the Delaware Chancery Court found that two members of the special litigation committee were not independent.<sup>150</sup> This was because they were both current board members of Oracle and professors at Stanford University and they were supposed to investigate fellow board members who also had significant ties to the university.<sup>151</sup> One of the targets of the investigation, also a professor at Stanford, had been a professor to one of the special litigation committee members during the committee member’s Ph.D. studies.<sup>152</sup> Another target was a Stanford alumnus who had made millions of dollars in contributions to Stanford, including contributions to an institute

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142. See *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1055 (Del. 2004) (“Unlike the demand–excusal context, where the board is presumed to be independent, the SLC has the burden of establishing its own independence by a yardstick that must be like Caesar’s wife—above reproach.” (quoting *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985)) (internal quotation marks omitted)).

143. *Cal. Pub. Emps.’ Ret. Sys. v. Coulter*, No. Civ.A. 19191, 2002 WL 31888343, at \*7 (Del. Ch. Dec. 18, 2002) (internal quotation marks omitted).

144. *Lewis*, 502 A.2d at 964.

145. *Id.* at 965.

146. *Id.*

147. *Id.*

148. *Id.*

149. *Lewis*, 502 A.2d at 965.

150. *In re Oracle Corp. Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003).

151. *Id.*

152. *Id.*

with which one of the special litigation committee members was closely affiliated.<sup>153</sup> The third target was the Oracle CEO who had also donated millions to the university and was considering an additional \$100 million donation at the time of formation of the special litigation committee.<sup>154</sup>

*In re Oracle* has been seen as setting a high standard for independence, clearly distinguishing the special litigation committee independence standard from other contexts, such as independence required to consider a pre-suit demand or to approve a merger. Just a year before the *In re Oracle* opinion was issued, the same court had stated, in the context of a board decision to approve a cash-out merger, that “a long-standing 15-year professional and personal relationship between a director and the CEO and [the director and the] Chairman . . . were insufficient to support a finding of control.”<sup>155</sup> This was so unless the plaintiff could point to specific facts regarding “the length, nature or extent of those previous relationships that would put in issue that director’s ability to objectively consider the challenged transaction.”<sup>156</sup> The court mentioned employment benefits as a theoretical example that could render the director with a sense of indebtedness to the controlling person.<sup>157</sup>

In *California Public Employees’ Retirement System v. Coulter*, the Delaware Chancery Court explained that even though personal friendships outside business relationships and approving of or acquiescing in the challenged transactions are each, alone, insufficient to establish lack of independence, an aggregate of them may well do the trick.<sup>158</sup> The plaintiff succeeded in establishing a reasonable inference of lack of independence of a special litigation committee member by showing that the director and the CEO, who was also the largest single shareholder, were lifelong friends.<sup>159</sup> The livelihood of the son of the director depended on the CEO because the son was the general manager of the company’s subsidiary.<sup>160</sup> The director had approved or acquiesced to all of the alleged self-dealing transactions of the

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153. *Id.* at 920–21.

154. *Id.*

155. *Orman v. Cullman*, 794 A.2d 5, 27 (Del. Ch. 2002) (internal quotation marks omitted).

156. *Id.* at 27 n.55.

157. *Id.*

158. *See Cal. Pub. Emps.’ Ret. Sys. v. Coulter*, No. Civ.A. 19191, 2002 WL 31888343, at \*9 (Del. Ch. Dec. 18, 2002).

159. *Id.*

160. *Id.*

CEO, and the director also benefited financially from some of the self-dealing transactions.<sup>161</sup>

### III. THEORY OF INDEPENDENCE AND CRITICISM THEREOF

Even without agreed standards on independence, board independence has been presumed to improve company performance, not only by the mass media—Sorkin, Hymowitz, Pulley, Grover, etc.—but also by many of the academics and practitioners in the field of corporate governance. Independent directors are perceived as an important mechanism for reducing the agency costs created by separating ownership from management.<sup>162</sup> Among the first scholars to advocate increasing board independence was William O. Douglas, in 1934.<sup>163</sup> Ahead of his time, Douglas emphasized that independent directors must have the power to make decisions in the company to effectively protect the interests of the shareholders.<sup>164</sup> Much of what Douglas advocated has become reality in the modern corporate governance system.

As Professor Jeffrey N. Gordon has shown, the proportion of independent directors on public company boards has been growing since the 1950s, when it was a mere 20%, rapidly through the decades and amounting to a staggering 75% in 2000.<sup>165</sup> As Gordon has described:

Circa 1950, . . . [it was perceived] that boards should consist of the firm's senior officers, some outsiders with deep connections with the firm (such as its banker or its senior outside lawyer), and a few directors who were nominally independent but handpicked by the CEO. Circa 2006, . . . [in contrast, boards ought to consist of] "independent directors," whose independence is buttressed by a range of rule-based and structural mechanisms. Inside directors are a dwindling fraction; the senior outside lawyer on the board is virtually an extinct species.<sup>166</sup>

In fact, as Bainbridge has remarked, the average public company board today has only one insider—the CEO.<sup>167</sup>

Furthermore, independent directors are thought to have more industry-specific information that they have gained from sitting on boards of other companies in the same industry, as compared to inside

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161. *Id.*

162. BAINBRIDGE, *supra* note 19, at 190.

163. See generally William O. Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

164. See *id.* at 1312–14.

165. Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465, 1471 (2007).

166. *Id.* at 1468.

167. BAINBRIDGE, *supra* note 19, at 188.



directors.<sup>168</sup> More generally, independent directors are perceived to have better access to external resources that allow the firm to make more informed decisions.<sup>169</sup> Mace has embraced that the independence requirement provides an effective check on management.<sup>170</sup> According to him, only outside directors can provide true advice and counsel, discipline management if required, effectively handle crises, approve objectives and policies proposed by management, ask discerning questions, and critically evaluate the performance of management.<sup>171</sup>

As for what the board's role should be, hot debate began in the 1970s, as Mitchell has described.<sup>172</sup> A jumpstart for the discussion came from Mace, who conducted an expansive research study on corporate directors.<sup>173</sup> Mace found that there is a large gap between what directors are supposed to do and what they actually do; rather expressively, he called directors "ornaments on the corporate Christmas tree."<sup>174</sup> Mace found that directors did not typically devote much time to board activities and that board members were, at best, a source of information to management.<sup>175</sup> Board meetings were not forums for active discussion arising out of the directors' questions; rather, they were rituals to be performed according to a predetermined script.<sup>176</sup>

Later on, Professor Melvin Aron Eisenberg put forth the monitoring board model, under which independent directors are a necessary component for monitoring the managers (hiring and terminating the CEO and senior officers, checking the corporation's auditing process and voting on conflict-of-interest transactions) rather than micromanaging the corporate affairs (acting on only the most important corporate decisions).<sup>177</sup> He noted that this model can work only if the directors have access to accurate and reliable information and if the majority of the board is independent.<sup>178</sup> Eisenberg's model found its way to the early versions of the American Law Institute's *Princi-*

168. *Id.* at 189.

169. *See id.* at 189-90.

170. *See Mace, supra* note 96, at 302-03.

171. *Id.*

172. Mitchell, *supra* note 97, at 27-35.

173. *See generally* MYLES L. MACE, *DIRECTORS: MYTH AND REALITY* (1971).

174. *Id.* at 107.

175. *See Mace, supra* note 96, at 293-94.

176. *See id.* at 295-96.

177. Melvin Aron Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187, 204-05 (1983).

178. *Id.* at 205.

*ples of Corporate Governance*.<sup>179</sup> However, as a response to harsh criticism by industry participants, most importantly the Business Roundtable, the ALI retracted its restatement-of-law-formed proposal that included mandatory requirements.<sup>180</sup> Instead, the ALI provided a final draft with mere recommendations.<sup>181</sup> Among academics, Professor Roberta S. Karmel criticized the ALI for presuming that the interests of shareholders and of management are in conflict. According to her, managers and shareholders alike strive for efficiency and profit, so no conflict exists.<sup>182</sup>

According to the statement by the Business Roundtable in 1978, corporations should have remained free to decide whether the particular situation of their enterprise demands a lesser amount of non-management directors.<sup>183</sup> Whereas Mace has criticized this caveat by the Business Roundtable for rendering the requirement itself meaningless,<sup>184</sup> Professor Richard Epstein has noted that the optimal number of independent directors does depend on the nature of the business.<sup>185</sup> In addition, the optimal number depends on the tradeoff that has to be made between not having an additional inside director on the board.<sup>186</sup> Such an insider could provide valuable information about the specifics of the business and the industry.<sup>187</sup> Epstein has criticized the general attitude to perceive independent directors as “some kind of holy water that can be sprinkled over a corporation to save it from all sorts of intrigue on the part of its staff.”<sup>188</sup>

Perhaps due more to loyalty to their clients than to academic ambition, Martin Lipton, Steven A. Rosenblum, and Karessa L. Cain of Wachtell have also expressed skepticism as to whether excessive focus on independence can lead to good board composition.<sup>189</sup> According to them, it could be hard to find independent directors who also have the required expertise to be suitable for the task.<sup>190</sup> As they have

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179. See generally PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS § 3.03(a) (Tent. Draft No. 1, 1982).

180. See generally Joel Seligman, *A Sheep in Wolf's Clothing: The American Law Institute Principles of Corporate Governance Project*, 55 GEO. WASH. L. REV. 325 (1987).

181. *Id.* at 351.

182. Roberta S. Karmel, *The Independent Corporate Board: A Means to What End?*, 52 GEO. WASH. L. REV. 534, 551–52 (1984).

183. See Bus. Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation*, 33 BUS. LAW. 2083, 2108 (1978).

184. Mace, *supra* note 96, at 297–98.

185. Richard A. Epstein, *In Defence of the Corporation*, 2004 N.Z. L. REV. 707, 719.

186. *Id.*

187. *Id.*

188. See *id.*

189. See Memorandum from Lipton et al., *supra* note 64, at 18.

190. *Id.*

noted, "The reality is that directors who meet today's stringent standards of independence may be relatively inexperienced in the company's business and lack real expertise and understanding of relevant industries and markets."<sup>191</sup> "The emphasis on director independence should not cause the board to lose sight of the importance of a well-functioning board and an effective partnership between the board and senior management."<sup>192</sup>

#### IV. ALTERNATIVES TO INDEPENDENCE

##### A. *Why Focus on Independence Is Not Appropriate*

###### 1. The Incentive Problem

Scholars Paul Mallette and Karen Fowler, as well as scholar Rita D. Kosnik, explain that under managerial hegemony theory, management dominates the board regardless of how many independent directors the board includes.<sup>193</sup> According to Mallette, Fowler, and Kosnik, the independent board members are ineffective because they are selected by management and, therefore, are likely to agree with the company's current methods of operation.<sup>194</sup> Second, outside directors have to rely on the information provided to them by the management, especially company-specific, inside information.<sup>195</sup> Outside directors are often CEOs of other companies and are likely not to challenge the management decisions more than they would like to be challenged by their own boards. This phenomenon is commonly called the structural bias.

However, Eliezer M. Fich and Anil Shivdasani, scholars in financial economics, tend to disagree.<sup>196</sup> According to the reputational capital theory, independent directors of public corporations have a strong incentive to monitor the management: if the firm whose board they serve faces a financial fraud lawsuit, the independent directors will experience a decline in other directorships offered to them.<sup>197</sup> There are also a number of shaming mechanisms to which directors are subject, such as monitoring by shareholder activists and inclusion in the

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191. *Id.*

192. *Id.*

193. Rita D. Kosnik, *Greenmail: A Study of Board Performance in Corporate Governance*, 32 ADMIN. SCI. Q. 163, 171 (1987); Paul Mallette & Karen L. Fowler, *Effects of Board Composition and Stock Ownership on the Adoption of "Poison Pills"*, 35 ACAD. MGMT. J. 1010, 1014 (1992).

194. See Kosnik, *supra* note 193, at 166-67; Mallette & Fowler, *supra* note 193, at 1014.

195. See Kosnik, *supra* note 193, at 167.

196. See generally Eliezer M. Fich & Anil Shivdasani, *Financial Fraud, Director Reputation, and Shareholder Wealth*, 86 J. FIN. ECON. 306 (2007).

197. See *id.* at 308.

California Public Employees' Retirement System's annual focus list on firms that have poor corporate governance.<sup>198</sup> This would seem to give independent directors an external incentive to perform as independently as possible.

As Charles M. Elson and Michael C. Jensen have noted, even though independent directors would not have an inherent incentive to monitor the management and thereby promote shareholder interests, this could be changed if independent directors were required to own stock in the company.<sup>199</sup> Outside directors who are also major shareholders in the company are widely used in both Germany and Japan where banks act dually as lenders and shareholders for their clients, as Professor Laura Lin has noted.<sup>200</sup> In fact, the Delaware Supreme Court has given special deference to outside directors who held substantial equity stakes in a corporation that was the target of a takeover.<sup>201</sup> As Clarke has noted, outside directors also being shareholders of the company is generally perceived as a positive thing under United States corporate law.<sup>202</sup>

Traditionally, companies have compensated directors for board membership at a flat fee, unaffected by the company performance.<sup>203</sup> Moreover, directors usually earn significant compensation from their primary occupation outside the directorship.<sup>204</sup> Perhaps a more realis-

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198. See BAINBRIDGE, *supra* note 19, at 171.

199. Charles M. Elson, *Executive Overcompensation—A Board-Based Solution*, 34 B.C. L. REV. 937, 939 (1993); Michael C. Jensen, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, 48 J. FIN. 831, 864–65 (1993).

200. Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 919–21 (1996).

201. See, e.g., *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1380 (Del. 1995) (“The subjective premise was the Court of Chancery’s *sua sponte* determination that Unitrin’s outside directors, who are also substantial stockholders, would not vote like other stockholders in a proxy contest, i.e., in their own best economic interests.”).

202. See Clarke, *supra* note 25, at 81–82.

203. See Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 135–56 (1996) (explaining the history of director compensation). While studies on board compensation show that equity compensation of boards has increased, most companies still compensate their directors at least partly in cash. See Harley E. Ryan Jr. & Roy A. Wiggins III, *Who Is in Whose Pocket? Director Compensation, Board Independence, and Barriers to Effective Monitoring*, 73 J. FIN. ECON. 497, 517–20 (2004) (finding that the proportion of cash in board compensation decreased by 20% and the proportion of equity increased by 78% between 1995 and 1997 in a sample of 600 public companies). Jack Dolmat-Connell and Gerry Miller have argued that the form of board compensation should depend on the perceived role of the board. Jack Dolmat-Connell & Gerry Miller, *What Should We Pay Board Members for?*, DIRS. & BDS., Sept. 22, 2008, at 34, 34. If the main responsibility of directors is to monitor the management, their compensation should be in cash. *Id.* If the board’s main role, in contrast, is to improve company performance, the compensation should be in equity. *Id.*

204. Lin, *supra* note 200, at 916.

tic alternative to requiring directors to buy stock would be to compensate them with stock instead of cash, as proposed by Elson.<sup>205</sup> As such, the interests of the directors would be aligned with those of the shareholders rather than those of the management.<sup>206</sup> Gordon, however, has noted that stock compensation may create perverse incentives for directors similar to those of the CEOs who engage in aggressive accounting methods to boost their incentive-based compensation.<sup>207</sup> According to Bainbridge, restricted stock is the best compensation alternative because it gives the directors the incentive to improve the firm performance and avoid losses.<sup>208</sup>

## 2. Empirical Evidence

In light of the trend towards more independence, scholars have asked whether there is evidence showing that director independence actually makes companies perform better. Results of empirical studies are mixed.<sup>209</sup> Some scholars, such as Stuart Rosenstein and Jeffrey G. Wyatt, have found a positive share price reaction to nominations of independent directors.<sup>210</sup> Benjamin E. Hermalin and Michael S. Weisbach have shown that when a firm performs poorly, insider directors are more likely to resign from the board and outsiders are more likely to be added.<sup>211</sup> According to Hermalin and Weisbach, this could possibly be because after insiders, who are responsible for the poor performance, are removed, the firms fill these vacancies (for the lack of good insider candidates) by recruiting outside directors;<sup>212</sup> otherwise, this could be because outsiders are added or specifically due to their being better at monitoring management, and to make room for these outsiders, inside directors had to be removed.<sup>213</sup> However, it would seem that these studies merely confirm that shareholders presume performance improvement due to director independence and that boards are aware of this presumption.<sup>214</sup> Gordon has concluded

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205. See Elson, *supra* note 203, at 164–73.

206. See *id.*

207. Gordon, *supra* note 165, at 1487–88.

208. BAINBRIDGE, *supra* note 19, at 170.

209. See Note, *Beyond "Independent" Directors: A Functional Approach to Board Independence*, 119 HARV. L. REV. 1553, 1553 (2006).

210. See generally Stuart Rosenstein & Jeffrey G. Wyatt, *Outside Directors, Board Independence, and Shareholder Wealth*, 26 J. FIN. ECON. 175 (1990).

211. See Benjamin E. Hermalin & Michael S. Weisbach, *The Determinants of Board Composition*, 19 RAND J. ECON. 589, 604–05 (1988).

212. *Id.*

213. See *id.* at 605.

214. Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1284–85 (1982).

that there is no correlation between having independent board members and better firm performance; however, in the aggregate, having independent directors improves the overall economy by making the capital markets more efficient.<sup>215</sup>

Barry D. Baysinger and Henry N. Butler found that adding independent board members has a positive net effect on the firm performance up to their accounting for 30% of the total board size, but that adding independent board members beyond that had a negative effect on firm performance.<sup>216</sup> In another study, they found that the positive reaction in firm performance may come with delay and that board composition is merely one of many mechanisms in controlling management.<sup>217</sup> Also, Michael H. Schellenger, David D. Wood, and Ahmad Tashakori found a positive correlation between independent directors and firm performance.<sup>218</sup>

However, these studies finding some degree of positive correlation are far outnumbered by studies that found a negative correlation or no correlation between the two variables.<sup>219</sup> For example, Hermalin and Weisbach have, in a later study, found that there is no significant correlation between board composition and firm performance.<sup>220</sup> Sanjai Bhagat and Bernard Black found in their study of a large sample of public companies over an extended period of time that, even though firms with poor performance tended to add more independent directors to remedy their poor performance, this strategy did not help. In fact, the companies possibly performed worse as a result.<sup>221</sup> These authors also noted that adding insiders on the board had a positive effect on the firm performance.<sup>222</sup>

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215. Gordon, *supra* note 165, at 1468–69.

216. Barry D. Baysinger & Henry N. Butler, *Revolution Versus Evolution in Corporation Law: The ALI's Project and the Independent Director*, 52 GEO. WASH. L. REV. 557, 575–76 (1984).

217. See Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 119–21 (1985).

218. Michael H. Schellenger et al., *Board of Director Composition, Shareholder Wealth, and Dividend Policy*, 15 J. MGMT. 457, 462–65 (1989).

219. See, e.g., Idalene F. Kesner & Roy B. Johnson, *An Investigation of the Relationship Between Board Composition and Stockholder Suits*, 11 STRATEGIC MGMT. J. 327, 332–34 (1990) (noting that the evidence on the existence of a correlation is mixed); Lin, *supra* note 200, at 925–26.

220. Benjamin E. Hermalin & Michael S. Weisbach, *The Effects of Board Composition and Direct Incentives on Firm Performance*, 20 FIN. MGMT. 101, 111 (1991).

221. See Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 J. CORP. L. 231, 248 (2002).

222. *Id.* at 263–64.

### B. *If Independence Is Not the Proper Focus, What Is?*

Based on theories and empirical studies discussed, it may be the case that the assumption that board independence improves company performance is misplaced. The question arises, therefore, as to what may be the proper focus if not independence. Key scholar Professor Lawrence E. Cunningham has proposed that it should be accounting expertise.<sup>223</sup> In fact, empirical studies unanimously show that expertise significantly improves board effectiveness.<sup>224</sup> For example, accounting experience on the part of board audit committee members has been found to reduce accounting earnings management. Anup Agrawal and Sahiba Chadha have found that companies that have independent board or audit committee members with financial expertise are less likely to restate their earnings.<sup>225</sup> Lawrence J. Abbott, Susan Parker, and Gary F. Peters have likewise found a negative correlation between having one or more financial experts on the audit committee and the company restating its earnings.<sup>226</sup> Andrew J. Felo, Srinivasan Krishnamurthy, and Steven A. Solieri have found that financial expertise of audit committee members improves the accuracy of the company's financial reports.<sup>227</sup> Gopal V. Krishnan and Gnanakumar Visvanathan have found a positive correlation between audit committee member accounting expertise and accounting conservatism; interestingly, such correlation was not found to exist between general financial expertise and accounting conservatism.<sup>228</sup>

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223. See Lawrence A. Cunningham, *Rediscovering Board Expertise: Legal Implications of the Empirical Literature*, 77 U. CIN. L. REV. 465, 465 (2008).

224. *Id.* at 466.

225. Anup Agrawal & Sahiba Chadha, *Corporate Governance and Accounting Scandals*, 48 J.L. & ECON. 371, 374 (2005).

226. See Lawrence J. Abbott et al., *Audit Committee Characteristics and Restatements*, 23 AUDITING: J. PRAC. & THEORY 69 (2004).

227. See generally Andrew J. Felo et al., *Audit Committee Characteristics and the Perceived Quality of Financial Reporting: An Empirical Analysis* (Apr. 2003) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=401240](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=401240).

228. Gopal V. Krishnan & Gnanakumar Visvanathan, *Does the SOX Definition of an Accounting Expert Matter? The Association Between Audit Committee Directors' Accounting Expertise and Accounting Conservatism*, 25 CONTEMP. ACCT. RES. 827, 851 (2008). Some studies have shown that, in the specific context of financial disclosures, independence may have a slight positive effect. See, e.g., Cunningham, *supra* note 223, at 473. This may, however, be due to the fact that accounting experts are usually outsiders to the firm (and the two qualities of expertise and independence thus coincide in this narrow context). See *id.* at 474. Therefore, it is doubtful whether independence, even in this context, has any added effect. See *id.* at 483-94. There is a strong negative correlation between board independence and accounting fraud. See, e.g., *id.* at 478; see also Abbot et al., *supra* note 226, at 70; Agrawal & Chadha, *supra* note 225, at 374; Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise Is the Received Wisdom?*, 95 GEO. L.J. 1843, 1872-73 (2007). But see Felo et al., *supra* note 227, at 25-26 (finding a positive correlation). In addition, board independence was positively

Cunningham has focused on arguing for the development of more stringent requirements of accounting expertise in public company board audit committees.<sup>229</sup> Even though it is traditionally perceived that expertise and independence are mutually exclusive qualities, this is not the case in audit committees because directors do not have to gain general accounting expertise from inside the company or even the industry.<sup>230</sup> On this point, Cunningham has distinguished corporate knowledge that executives have because of their tenure with a specific firm, i.e. status expertise, from expertise on a given subject matter.<sup>231</sup>

Also, the SOX definition of expertise in terms of formal training and accounting experience is in stark contrast to the general amorphous definition of independence that has been traditionally applied, by courts, for example.<sup>232</sup> Cunningham notes that even though the focus has so far been on accounting expertise, in the future, the focus could shift to other kinds of expertise as well; for example, members of the nominating committee could be required to have experience in designing executive compensation structures and market knowledge in executive recruitment.<sup>233</sup>

Interestingly, even though expertise enhances board performance, law discourages expertise by imposing a higher standard of liability on the more expert board members. In *In re Emerging Communications*, the Delaware Chancery Court held a director who was the only one on the board who had financial expertise to a higher standard than nonexpert board members in evaluating the fairness of the merger price in a cash-out merger.<sup>234</sup> The director had voted for the merger at a price of \$10.25 per share even though the court viewed that the director (being a principal and general partner of an investment advising firm, with significant experience in finance and the telecommunications sector) was “in a unique position to know that” the company could get as much as \$20 per share.<sup>235</sup> The director had also made a

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related to the market's favorable reaction to the board announcements of earnings forecasts. See Irene Karamanou & Nikos Vafeas, *The Association Between Corporate Boards, Audit Committees, and Management Earnings Forecasts: An Empirical Analysis*, 43 J. ACCT. RES. 453, 481 (2005).

229. Cunningham, *supra* note 223, at 467.

230. *Id.*

231. *Id.* at 494.

232. See Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 407, 116 Stat. 745, 790 (codified at 15 U.S.C. § 7265 (2006)), for the considerations of a financial expert under SOX.

233. Cunningham, *supra* note 223, at 484.

234. *In re Emerging Commc'ns, Inc. S'holders Litig.*, No. Civ.A. 16415, 2004 WL 1305745, at \*39–40 (Del. Ch. May 3, 2004).

235. *Id.* at \*39.



statement to this effect.<sup>236</sup> The court stated that the director should have voted against the merger and advocated that the board reject the unfair price.<sup>237</sup>

## V. INDEPENDENCE IS CRUCIAL TO CRISIS MANAGEMENT

Although this Article has taken the position and provided support for the proposition that, for ordinary, business-as-usual situations, expertise actually outweighs independence in regards to a board's contribution to a company's performance, there are exceptions to this rule. Even Cunningham has noted that, despite the general correlation between board independence and poor corporate performance, there is slightly more evidence that independence enhances the performance of specific tasks of the board.<sup>238</sup> According to Mace, the role of directors changes from an advisory one to that of decision makers when the CEO dies suddenly and the board has to select a successor or when the CEO's performance is so unsatisfactory that the CEO has to be changed.<sup>239</sup>

Lin's survey of empirical studies on the effects of board independence in specific corporate crises tends to support Cunningham's conclusion.<sup>240</sup> According to Lin, board composition has a positive effect in the following scenarios. First, when a firm is performing poorly, a board with more outside directors is more likely to dismiss the CEO.<sup>241</sup> Second, boards with more outside directors are more likely to adopt efficient executive compensation plans, including greater use of equity-based compensation and lesser use of management perks in slow markets.<sup>242</sup> Third, independent boards make more shareholder-wealth-increasing decisions on adopting poison pills than non-independent boards.<sup>243</sup> Independent boards also make better shareholder-wealth-increasing decisions on greenmail, golden parachutes, and management buyouts.<sup>244</sup>

It seems that crisis situations are when independent directors have the greatest impact, as Bainbridge has remarked.<sup>245</sup> A corporate scandal may be the very type of crisis that the numerous scholars have

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236. *Id.* at \*39-40.

237. *Id.*

238. Cunningham, *supra* note 223, at 471-72.

239. Mace, *supra* note 96, at 295.

240. Lin, *supra* note 200, at 926-39.

241. *Id.* at 926-27.

242. *Id.* at 927-29.

243. *Id.* at 931-33.

244. *Id.* at 933-39.

245. BAINBRIDGE, *supra* note 19, at 194-95; *see* Mace, *supra* note 96, at 295.

discussed. Even Perkins, who has been criticized the least for having ties to the Murdochs or News Corporation has said, upon exiting the board only months after the scandal began, that “if Rupert really wants me to stay I will but I really don’t want to.”<sup>246</sup> This did little to emphasize his unbeholdenness to Rupert Murdoch. As this Article has discussed in Part IV(A)(2), boards know that shareholders perceive independence as a benefit. The News Corporation board could have made at least a better show of independence for the benefit of the shareholders.<sup>247</sup> In contrast to the Murdochs’ commenting minimally, primarily when testifying, the board could have commented continually through press releases, providing updates and making most of the internal investigation that News Corporation was conducting.<sup>248</sup> Whereas the two top managers of *News of the World* have been arrested for allegedly participating in the criminal practices, the board could also have terminated these managers, emphasizing poor oversight as the cause and even presuming innocence on the part of the managers. Finally, the board could be providing updates on improvements being devised and developed to improve information systems so as to prevent any future lapses in management oversight and to ensure that the board finds out about such lapses earlier should they occur.

## VI. CONCLUSION

Even before stock exchanges required the majority of the board of every noncontrolled, publicly-traded company to be independent as a reaction to the Enron scandal, the proportion of independent directors on the board of the average public company had risen to an absolute majority. This is because board independence has been presumed, for many decades, to improve company performance by academics and practitioners of the field. This presumption also seems to be prevalent in the mass media—at least as is reflected in the discussion of the phone-hacking scandal involving News Corporation.

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246. Hymowitz et al., *supra* note 5.

247. See Andrew Edgecliffe-Johnson et al., *Murdochs Take \$1bn Hit on Share Falls*, FIN. TIMES (July 19, 2011), <http://www.ft.com/cms/s/0/e0b4d0c0-b15e-11e0-9444-00144feab49a.html#axzz1i3ZW7OeO> (noting that News Corporation’s share price plummeted 17.4% at the news of the scandal).

248. News Corporation, Annual Report (Form 10-K) (June 30, 2011) (“The Company has taken steps to solve the problems relating to *News of the World* including the creation and establishment of an independent Management & Standards Committee (the “MSC”), which will have oversight of, and take responsibility for, all matters in relation to the *News of the World* phone hacking case, police payments and all other connected issues at News International Group Limited (“News International”), including as they may relate to other News International publications.”).

The heralded benefits of director independence, some of which are theorized, have ranged from more informed decisions to increased industry knowledge, better access to external resources, and, most prominently, reduction of agency costs by providing an effective check on management through monitoring. However, it has been found that there is a large gap between what directors are supposed to do and what most actually do.

Moreover, there is a lack of consensus on the exact definition of independence; there is too little coherence between the standards imposed by federal law, the standard imposed by Delaware law, and the standards of the stock exchanges. The SOX independence standard for audit committee members is stringent and well-defined, but the problem is that this standard has only a narrow application. The SEC disclosure requirements seem to be fairly progressive, but the enforcement mechanism for errors, short of clear fraud, is unsettled. The main flaw of the stock exchange independence standards seems to be that they capture neither personal relationships nor private dealings between directors and managers because of the excessive focus on the director's relationship with the company. Personal relationships between directors and members of the Murdoch family seemed to be the criticism by the mass media as to most of the independent directors of News Corporation, with the private transactions thought to be the most compromising to independence. The state-law standard in Delaware is the most board favorable and is also unclear because it is so context specific. It is clear that none of the relationships between the News Corporation directors and the Murdoch family members would fail to meet the Delaware standard, except perhaps the standard for the independence of a special litigation committee.

Even if board tasks and independence were better defined, incentive theories explain well why independent board members still might not actually be good monitors. There are some solutions available to remedy the lack of incentives—such as more widespread adoption of restricted stock as primary compensation for board members—but it seems fairly clear, based on the expansive empirical evidence, that the independence of board members has little or no effect on the performance of a company. However, exceptions exist for certain corporate crises, of which the Murdoch scandal is an example.

It is probably unfounded, based on the data from the studies, for the mass media to presume that greater independence of the News Corporation directors would have resulted in the directors' advisement of a better acquisition strategy. However, it is likely that the directors would have provided a timelier, strategically better response

to the phone-hacking scandal. For better acquisition strategies and perhaps better oversight of the managers of *News of the World*, MySpace, or Dow Jones, director expertise would probably be a better point of focus than independence. There has been a trend towards increasing expertise requirements, and this will most likely continue in the future. Perhaps there will be a time when Natalie Bancroft would not qualify for membership on the board of a global news conglomerate, at least not based on her primary occupation as an opera singer.

